Securities Industry
Trends
AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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SIA TRENDS FLASH...1986'S STELLAR START CONFIRMED

This past May Day, SIA projected that this year's first quarter would see the securities industry post a record $2 billion in pre-tax profits. All the data is now in and the results are...a new record $2 billion in pre-tax profits, $1.945 billion to be more precise. The projection was based on results of the top 15 New York Stock Exchange firms doing a public business in this year's first quarter and their 1985 full year and Q4 performance, measured against their share of 1985's full year and Q4 performance for all NYSE firms doing a public business. The May TRENDS' Flash also projected 1986 Q1 industry revenues of about $13 billion. The final results...$13 billion, or $12.895 when carrying the decimal out a few notches. Likewise, projected expenses were $11 billion. Actual results...$11 billion ($10.950 billion for precision).

For the industry as a group, the new record quarter holds some promising statistics. This time, while the industry was posting record revenues it was able to keep expenses from outpacing the gains. Revenues increased a hefty 11% from 1985's fine final quarter. Expenses increased but much less so...only 8%. That left a lot of room for improvement on the bottom line. And improve it did. This year's first quarter showed a 32% increase in pre-tax net income over Q4 1985's then second best ever showing and was 20% better than the previous record quarter, 1982 Q4.

REVENUE RAISERS

The two biggest revenue contributors in the securities industry, trading gains and commissions, improved dramatically this past quarter. Trading gains (from principal transactions/market making) shot up 31% to $4 billion. Commissions rose 23% to $2.8 billion. Trading gains' relative importance to total revenues continued its growing dominance. This past quarter it accounted for 31% of all revenues, much more than full year 1985's 26% and maintained its steady increase (it was less than 20% back in 1980). Commissions relative importance had dropped steadily from 35% of all revenues in 1980 to 21% last year. The first quarter did not, however, show any further erosion with commissions maintaining its 21% foothold.

STATEMENT OF INCOME
TOTAL SECURITIES INDUSTRY*
(In $ millions)

	Q4 1985	Q1 1986	% Increase
REVENUES			
Commissions	$ 2,251	$ 2,761	23
Gains/Losses from Trading Accounts	3,033	3,969	31
Gains/Losses from Investment Accounts	427	599	40
Profits/Losses from Underwriting	1,531	1,141	(25)
Margin Interest	708	700	(1)
Sales of Investment Company Shares	386	634	64
Fees-Supervision, Advisory, Administrative	294	272	(7)
Revenue from Research Services	3	5	67
Commodities Revenue	152	164	8
Other Revenue - Securities - Related	2,280	2,152	(6)
Other Revenue	532	498	(6)
Total Revenue	$11,597	$12,895	11
EXPENSES			
RR Compensation	$ 1,911	$ 2,233	17
Clerical & Admin. Employee Expenses	1,815	2,047	13
Partners & Officers - Employment Expenses	298	357	20
Other Employee Comp.	82	100	22
Floor Expenses	348	412	18
Communications	493	534	8
Occupancy & Equipment	504	510	1
Promotional Costs	260	212	(18)
Interest Expense	3,201	3,160	(1)
Losses - Errors and Bad Debts	85	110	29
Data Processing Costs	129	146	13
Non-recurring Charges	60	5	(92)
Regulatory Fees and Expenses	77	62	(19)
Other Expenses	860	1,062	23
Total Expenses	$10,123	$10,950	8
Pre-Tax Net Income	$1,474	$1,945	32

*Based on NYSE firms doing a public business

But just maintaining today's lower 21% slice of revenues is not saying much for commission business. Since last August the underlying transactions for commission business, equity sales, have exploded. According to SIA's Investor Activity Report, the newest and most sophisticated measurement of member/institutional/retail trading activity which tracks actual institutional and member trades (and is not just an arbitrary proxy measurement), both overall equity business and the commission intensive retail equity business has skyrocketed in all markets from last August through the end of the first quarter. For the Big Board, total share volume doubled during this period while its retail portion was up over 60%. For the AMEX, both overall and retail activity more than doubled while the OTC market showed similar gains in overall activity. Thus, last year's decline in commissions' contributions to all revenues and this past quarter's holding steady level is disappointing in the face of an exploding equity market. And since the explosion waned since March, the second quarter's showing may not even hold at 21%. Still, $2.8 billion is a lot of commission dollars and surely helped the bottom line.

The gain in trading gains' share of revenues is gratis of an exploding secondary debt market (where the preponderance of these revenues are made). SIA's Investor Activity Report also shows this market exploding (as measured by professional institutions' secondary trading of corporate debt). The gains could have even been more impressive if the muni market hadn't collapsed during the first quarter (see 4/9/86 TRENDS).

It was this muni fall-off which contributed to the only major drop-off in any revenue line...underwriting. The first quarter's 25% drop-off (compared to 1985 Q4) in underwriting revenues is directly attributable to a dead muni market. The corporate syndication sector was fine...in fact, it was booming. From January through March, underwriters booked nearly $70 billion of corporates, half of all 1985's business. But munis collapsed. Less than $12 billion made it through the first quarter window...only 5% of last year's total. Fortunately, munis so far are making a second quarter comeback while corporate continues at torrid levels.

The few other revenue lines which were down were down only slightly from 1985 Q4. Margin interest eased 1%, not bad considering a much more precipitous drop in interest rates during the quarter, while reduced M&A activity partly contributed to a 6% easing of securities related other revenue.

COSTS CONTROLLED

The increase in the industry's major expense factor, people costs, averaged less than the increases in the industry's major revenue lines. Thus, the bottom line improved from both a relative and aggregate viewpoint. The bite out of revenues taken by RRs, clerks, partners and other employees' wages

edged up slightly in 1986 Q1 from 1985 Q4, but was still less than full year 1985's bite or less than any full year during the Eighties for that matter.

The interest rate easing during the quarter, though it tempered revenues from margin interest, was counterbalanced when it reduced the income statement's biggest expense item, interest expense (since employee costs are sub-divided). That's pretty impressive since the liability side of the industry's balance sheet continued its rapid increase during this quarter. Average liabilities increased 15% to about $380 billion (from 1985 Q4 to 1986 Q1).

While some reduced expenses, such as a 92% cut in non-recurring charges, were beyond any conscious cost cutting abilities, others, such as an 18% drop in promotional costs, were indicative of the Street's efforts to not let costs run away from them during bull markets...a sign that maybe the boom/bust lesson has finally been learned.

REMARKABLE RATIOS

All this rosy revenue, controlled cost analysis boils down to one thing...it was a great quarter. The ratio's were terrific. The first quarter's 44.5% pre-tax return on equity was only exceeded once on a full year basis since 1973 when data was first available. And that 44.5% didn't fall far short of the record pre-tax ROE, 1980's full year 49.2%. Even better, the quarter's 15.1% profit margin exceeds all full-year margins since the data became available in 1973. And while we don't wish to pay lip service to the fires of optimism, if that doesn't say enough about this record quarter and the current bull year, nothing else can.

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